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Income Tax Consequences On Partition And Sale Of Land

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INCOME TAX CONSEQUENCES ON PARTITION AND SALE OF LAND

— by Neil E. Harl*

Partition and sale of land,¹ while not exactly a common occurrence, is always available if the co-owners cannot agree on buying out one or more of the co-owners or selling the property and splitting the proceeds. A question of some importance: what are the income tax consequences, particularly for a co-owner who buys the property in the partition and sale proceeding?

General rule

In general, gain or loss is realized on sales or exchanges of property.² Moreover, the entire amount of gain or loss is recognized unless one of the provisions dealing with tax-free exchanges applies.³ Thus, gain can be avoided in the case of like-kind exchanges,⁴ involuntary conversions,⁵ corporate⁶ and partnership⁷ exchanges, corporate reorganizations,⁸ and sale or exchange of the principal residence, (within limits)⁹ to mention the major tax-free sales and exchanges.

In the event of a partition and sale, with all interests of co-owners divested in favor of new owners, the usual consequences of a sale apply and gain or loss is recognized.¹⁰ A partition and sale is not considered to be an involuntary conversion. To be considered an involuntary conversion, the transaction must involve a situation where "property is compulsorily or involuntarily converted."¹¹ An involuntary conversion may be the result of "the destruction of property in whole or in part, the theft of property, the seizure of property, the requisition or condemnation of property, or the threat or imminence of requisition or condemnation of property."¹² If at least one of those conditions is met, gain is not recognized if the proceeds are converted into other property similar or related in service or use to the converted property.¹³

Purchase by a selling co-owner

In the event one of the co-owners of property subjected to a partition and sale action purchases the property at the partition sale, the partition proceedings constitute a nontaxable transaction for federal income tax purposes.¹⁴ The co-owner who purchases the property realizes neither taxable gain nor a deductible loss on the sale of the interest owned prior to the partition and sale action.¹⁵ IRS has ruled that in such circumstances, the purchasing co-owner sold nothing.¹⁶ The partition sale merely established a price at which the taxpayer could purchase the undivided interests of the other tenant or tenants in common.¹⁷

In a similar vein, in a 1928 Board of Tax Appeals case, the owner of an undivided interest in farm and timber land sold at public auction sustained no loss where the interest was purchased by the selling taxpayer.¹⁸ As was noted in the court opinion,

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“the relations of the petitioner and Moss as co-owners of the tract of land mentioned were not harmonious and litigation between them appeared probable....”¹⁹ Accordingly, the two co-owners entered into a contract providing for a public sale of the property involved.²⁰

As the Board of Tax Appeals observed, the taxpayer “sold nothing” and merely purchased the remaining interest.²¹ As with the later revenue ruling,²² the Board of Tax Appeals stated that “the only effect at the auction as to this acreage was to establish the price at which the petitioner purchased the undivided interest of Moss [the other co-owner] therein.”²³ As a consequence the taxpayer neither realized a taxable gain nor sustained a deductible loss from the sale of the taxpayer’s interest in the land.²⁴

In conclusion

The two primary authorities, *Rev. Rul. 55-77*²⁵ and *Hunnicut v. Comm’r*,²⁶ indicate that a selling co-owner of property who purchases the property in a partition and sale proceeding or other public auction recognizes neither gain nor loss as to the property interest sold. That is highly important for heirs who find themselves faced with a co-owner who wants out of the co-ownership arrangement but the parties are unable to agree upon the terms of sale. The selling co-owner who intends to acquire the property in a partition and sale action or in a public auction can rest assured that the transaction does not trigger gain (and will not produce a deductible loss).

FOOTNOTES

¹ See, e.g., Iowa Code, Ch. 651 (1999).

² I.R.C. § 1001(c).
³ See, e.g., I.R.C. §§ 1031, 1033.
⁴ I.R.C. § 1031.
⁵ I.R.C. § 1033.
⁶ I.R.C. § 351.
⁷ I.R.C. § 721.
⁸ I.R.C. § 368(a)(1).
⁹ I.R.C. § 121.
¹⁰ I.R.C. § 1001(c).
¹¹ Treas. Reg. § 1.1033(a)-1(a).
¹² *Id.*
¹³ *Id.*
¹⁴ Rev. Rul. 55-77, 1955-1 C.B. 339.
¹⁵ *Id.*
¹⁶ *Id.*
¹⁷ *Id.*
¹⁸ *Hunnicut v. Comm’r*, 10 B.T.A. 1004 (1928), *acq.*, C.B. VII-2, 19.
¹⁹ *Id.*
²⁰ *Id.*
²¹ *Id.*
²² Rev. Rul. 55-77, 1955-1 C.B. 339.
²³ *Hunnicut v. Comm’r*, 10 B.T.A. 1004 (1928), *acq.*, C.B. VII-2, 19.
²⁴ *Id.*
²⁵ 1955-1 C.B. 339.
²⁶ 10 B.T.A. 1004 (1928), *acq.*, C.B. VII-2, 19.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

GENERAL-ALM § 13.03.*

DISCHARGE. The debtor had granted a security interest in most of the debtor’s farm property to a bank. The debtor also purchased farm supplies on credit from a supplier. The supply credit was unsecured until the debtor told the supplier that the debtor was having a hard time paying bills. The supplier asked the debtor to grant a security interest in the debtor’s crops to collateralize the supply debt, which the debtor voluntarily agreed to do. The debtor was able to plant another crop without any additional debt and scaled back the farm operation and moved to a cheaper residence to decrease expenses. The debtor sold most of the crop to a third party who was not listed as a potential buyer on the security agreement with the supplier; however, the debtor sold some of the crop to the supplier who allowed the debtor to keep the proceeds. The debtor used the proceeds of the sale of crop to the supplier to pay other debts of the farm. The supplier sought a ruling that the debt to the supplier was nondischargeable for willful and malicious

injury to the supplier’s security interest in the crops. The court found that the debtor’s actions were focused on saving the farm as a viable operation, had taken several steps to reduce expenses and costs, was not aware that the law required the debtor to supplement the list of potential buyers if the crop was sold to a non-listed buyer, and was not aware that use of the proceeds for farm debts was not a permitted use of the proceeds of collateral. Therefore, the court held that the debtor did not willfully or maliciously harm the supplier and the debt was dischargeable. *In re Crump*, 247 B.R. 1 (Bankr. W.D. Ky. 2000).

FEDERAL TAX-ALM § 13.03[7].*

AVOIDABLE LIENS. The IRS had filed two tax liens against the debtor’s property prepetition. The debtor sought to avoid the liens under Section 522(f)(1) as impairing the debtor’s exemptions. The court held that Section 522(f)(1) could not be used to avoid a federal tax lien because (1) the lien is created by statute and is not a judicial lien and (2) under North Carolina law, the exemptions are inapplicable as to federal tax liens; therefore, no exemptions are impaired by the tax lien. *In re Morgan*, 2000-2 U.S. Tax Cas. (CCH) ¶ 50,596 (Bankr. E.D. N.C. 2000).